DEPARTMENT OF STATE REVENUE

01-20171269.LOF

Letter of Findings: 01-20171269
Individual Income Tax
For the Years 2013 through 2015

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

Individuals were unable to provide sufficient documentation to establish that the research expense credits claimed by a flow-through business in which Individuals were shareholders were valid. Therefore, Individuals were unable to claim the research expense credits on their individual income taxes.

ISSUES

I. Adjusted Gross Income Tax - Research Expense Credits Regulations.

Authority: IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-2; IC § 6-3.1-4-4; IC § 6-8.1-5-1; IC § 6-8.1-5-4; *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Indiana Dep't of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *New Colonial Ice Co. v. Helvering*, 292 US. 435 (1934); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7th Cir. 1998); *Norwest Corp. & Subsidiaries v. Comm. Of Internal Revenue*, 110 T.C. 454 (1998); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); Treas. Reg. § 1.41-4; 66 F.R. 280-01; 66 F.R. 66362-01; 69 F.R. 22-01; *Comments on Research Credit Regulations*, 2001-10 I.R.B. 784, 2001 WL 84197; Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017); Letter of Findings 01-20150385 (December 6, 2016); Letter of Findings 02-20130676 (January 16, 2015).

Taxpayers argue that the Department erred in denying research and expense credits claimed by the company of which they were shareholders on the ground that the Department imposed a "discovery" test not found in Indiana law.

II. Adjusted Gross Income Tax - Qualified Research Expense Projects.

Authority: IC § 6-3.1-4-1; IC § 6-8.1-5-4; IC§ 6-8.1-5-1; *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 897 N.E.2d 289 (Ind. Tax Ct. 2007); *United States v. McFerrin*, 570 F.3d 672 (5th Cir. 2009); *Stinson Estate v. United States*, 214 F.3d 846 (7th Cir. 2000); *Conklin v. Town of Cambridge City*, 58 Ind. 130 (1877); *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); I.R.C. § 41; I.R.C. § 6001; Treas. Reg. 1.41-4; Treas. Reg. 6001-1; Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017); Letter of Findings 01-20150385 (December 6, 2016).

Taxpayers argue that the Department erred in disallowing research expense credits attributable to specific projects engaged in by the company of which they were shareholders.

STATEMENT OF FACTS

Taxpayers ("Husband" and "Wife") are a married couple and are Indiana residents. Husband is a shareholder in a business ("Business") which manufactures tangible personal property ("TPP") primarily for industrial customers. As the result of a separate audit of Business, the Indiana Department of Revenue ("Department") determined that Business had claimed research expense credits ("REC") incorrectly and that those credits flowed through to Taxpayers on their individual Indiana income tax returns for the tax years 2013, 2014, and 2015. Specifically, the

Department reviewed a credit study prepared for Business by a third party firm ("Firm"). Due to the large number of projects which the Firm believed could have REC implications, Firm selected a sample of the projects, reviewed them for REC relevance, and projected those rates. In its audit, the Department concluded that none of the projects included in the sample qualified for REC activities and disallowed the claimed REC for Business. Since Business is a flow-through entity, the Department adjusted Taxpayers' returns for those years, removing the claimed RECs which had flowed through to Husband from Business, and issued proposed assessments for individual income tax, penalties, and interest. Taxpayers protested the proposed assessments. An administrative hearing was held and this Letter of Findings results. Because the REC determination is based on Business' audit, this Letter of Findings will primarily address that audit and the tax consequences that flowed from it. Further facts will be supplied as required.

I. Adjusted Gross Income Tax - Research Expense Credits Regulations.

DISCUSSION

Taxpayers protest that the Department relied on the wrong set of federal regulations to reach its conclusions. The primary question is, for the years at issue, whether Indiana's version of the Research Expense Credit impose the T.D. 8930 "Discovery Test" or the less restrictive T.D. 9104 "Uncertainty Test." The Department determined that Taxpayer erroneously relied on regulations published in Treasury Decision 9104 (T.D. 9104, 69 F.R. 22-01, 2004 WL 18938) in calculating its Indiana research expense credits. The Department found that T.D. 9104 was not promulgated and was not in effect until well over eleven months after the Indiana legislature adopted the research expense provisions provided at IC § 6-3.1-4-4.

As a threshold issue, it is the Taxpayers' responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the [D]epartment's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 897 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

The Department maintains the applicable regulations are found in Treasury Decision 8930 (T.D. 8930, 66 F.R. 280-01), 2001 WL 34028585. The Department notes that T.D. 8930 is the only set of regulations that were promulgated and in effect on January 1, 2001, the year in which Indiana's version of the credit was promulgated. The Department believes that T.D. 8930 imposes a discovery requirement. According to Taxpayer, the Internal Revenue Service ("I.R.S.") eliminated the "discovery requirement" and that Taxpayer was therefore entitled to rely on the less restrictive "elimination of uncertainty" test found in T.D. 9104.

The Department also notes that IC § 6-3.1-4-4 was amended by the Indiana legislature effective January 1, 2016, deleting the reference to January 1, 2001, to recouple with the current Internal Revenue Code and regulations, but that this amendment was only effective for tax years beginning either on or after January 1, 2016. Of course, this recoupling did not take effect until after the years under consideration here. Taxpayers argue that the "Discovery Test," T.D. 8930, was never meant to be applied and that the T.D. 9104 "Uncertainty Test" is the appropriate measure to determine if activities qualify for the credit.

IC § 6-3.1-4-1 provides that, "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims the tax credit is required to retain records necessary to substantiate a claimed credit. Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)); *see also United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009) (citing *Stinson Estate*) ("[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed."); *New Colonial Ice Co. v. Helvering*, 292 US. 435, 440 (1934) ("Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor[e] can any particular deduction be allowed.").

In order to obtain the benefit of the RECs at issue, both Indiana and federal law require that a taxpayer maintain and produce contemporaneous records sufficient to verify those credits. *See* Treas. Reg. § 1.41-4(d). Moreover, Indiana mandates that every person subject to a listed Indiana tax keep books and records, including all source documents "so that the [D]epartment can determine the amount, if any, of the person's liability for that tax by reviewing those books and records." IC § 6-8.1-5-4(a).

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-1-3.5(b). Indiana provides tax credits outlined in IC 6-3.1 which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense" tax credit under IC § 6-3.1-4-2(a), which states that, "A taxpayer who incurs Indiana qualified research expense in a particular taxable year is entitled to a research expense tax credit for the taxable year." IC § 6-3.1-4-1 defines the credit. In part, this statute - in effect for the taxable years in question - provides:

> "Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

The issue is which regulations were in effect at the time the Indiana legislature promulgated IC § 6-3.1-4-4: T.D. 8521 (eff. May 16, 1989); T.D. 8930 (eff. Jan. 3, 2001); or T.D. 9104 (eff. Jan. 2, 2004).

The Department maintains that T.D. 8930 was in effect for the years at issue. If so, the regulations impose a "Discovery Test" in which qualified research must be "undertaken for the purposes of *discovering information* which is technological in nature." (*Emphasis added*).

Taxpayers maintain that T.D. 9104 is relevant because it has persuasive value. These regulations incorporate a less restrictive "uncertainty" test in which qualified research is intended to *eliminate uncertainty* concerning the development or improvement of a business component. Taxpayer asserts that only T.D. 8521 was in effect on January 1, 2001, so it controls under Ind. Code § 6-3.1-4-4.

Taxpayers challenge the validity of the IC § 6-3.1-4-4 reference to the 2001 federal regulations. This reference to the 2001 I.R.C. and regulations was added by P.L. 192-2002, § 89 in 2002, which was the first time that IC § 6-3.1-4-4 referenced a specific date. The Department has historically applied the 2001 final regulations, published under T.D. 8930 (the "2001 Final Regulations"). The 2001 Final Regulations define qualified research and development under I.R.C. § 41 to include a discovery requirement. However, these regulations were not promulgated until January 3, 2001, not January 1, 2001 (the date referred in the statute), and no portion of the regulation was made retroactive.

T.D. 8930, published in the Federal Register on January 3, 2001, contains final regulations relating to the computation of the research expense tax credit under section 41(c) and the definition of "qualified research" under section 41(d). "These regulations reflect changes to section 41 made by the Tax Reform Act of 1986 (the 1986 Act), the Revenue Reconciliation Act of 1989, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Tax and Trade Relief Extension Act of 1998 (the 1998 Act) and the Tax Relief Extension Act of 1999 (the 1999 Act)." T.D. 8930, 66 F.R. 280-01. The 2001 Final Regulations set forth the discovery requirement for defining qualified research under I.R.C. § 41(d). Section 1.41-4(a)(3)(i) of the 2001 Final Regulations states:

> For purposes of section 41(d) and this section, research is undertaken for the purpose of discovering information only if it is undertaken to obtain knowledge that exceeds, expands, or refines the common knowledge of skilled professionals in a particular field of science or engineering.

T.D. 8930, 66 F.R. 280-01 at 290.

T.D. 8930 notes criticism by commentators to the proposed regulations (published in 1998) that this definition imposes a "discovery requirement" that was not mandated by I.R.C. § 41(d); however, the IRS and the Treasury Department elected to retain the Discovery Test because they "continue[d] to believe that section 41 conditions credit eligibility on an attempt to discover information that goes beyond the common knowledge of skilled professionals in the particular field of science or engineering" and that the legislative history of the Tax Reform Act of 1986 (the "1986 Act") supported such a definition. T.D. 8930, 66 F.R. 280-01. T.D. 8930 further explains that the 1986 Act narrowed the definition of the term "qualified research," and cites to legislative history explaining that "Congress was concerned that taxpayers had applied the original definition of qualified research 'too broadly,'" and under the 1986 Act research must be undertaken "*to discover information* that is technological in nature . . . ."

Id. at 282 (quoting H.R. Conf. Rep. No. 99-841, at II 71 n.3 (1986)).

T.D. 8930 additionally notes that the discovery requirement is consistent with the legislative intent of the 1999 Act. The legislative history of the 1999 Act states "[e]mploying existing technologies in a particular field or relying on existing principles of engineering or science is qualified research, if such activities are otherwise undertaken *for purposes of discovering information* and satisfy the other requirements under section 41." *Id.* at 283 (quoting H.R. Conf. Rep. No. 106-478, at 332) (*emphasis in original*). T.D. 8930 states:

> By referring separately to a requirement that the research be undertaken for purposes of discovering information, this legislative history again confirmed that the phrase "discovering information" is a separate substantive requirement and not merely a phrase used to link the term *research* with the types of information required as the subject of the research.

Id.

T.D. 8930 also refers to case law applying the Discovery Test subsequent to the 1986 Act and prior to promulgation of the 1998 Proposed Regulations and the 2001 Final Regulations. In *United Stationers, Inc. v. U.S.*, 163 F.3d 440 (7th Cir. 1998), the Seventh Circuit relied upon the plain language of § 41(d)(1)(B)(i) and the legislative history of the 1986 Act in determining that the taxpayer had not engaged in "qualified research" because it did not develop research programs for the purpose of discovering information. The Court stated, "Congress clearly intended . . . that qualifying research pass a high threshold of innovation and be of broad effect." *Id.* at 444; *see also Norwest Corp. & Subsidiaries v. Comm. Of Internal Revenue*, 110 T.C. 454, 489 (1998) (relying upon "ordinary meaning of the language used in the statute . . . as well as the legislative history surrounding the promulgation of the TRA 1986[.]").

Thus, T.D. 8930 clearly reflects the fact that the Treasury Department and the IRS considered the criticisms of the Discovery Test, yet chose to retain the requirement "[i]n light of the case law and the legislative history[.]" T.D. 8930. The 2001 Final Regulations did not spontaneously implement the Discovery Test, but instead rely upon legislative, statutory, and case law guidance evidencing that Congress intended to implement such a test with the enactment of the 1986 Act, and reiterated this position in the Tax Relief Extension Act of 1999 (the "1999 Act"). Because the interpretation of the 1986 Act and the 1999 Act by the IRS and courts, the "Discovery Test" was meant to be applied based on the statutory interpretation alone. Thus, Indiana's adoption of the "Discovery Test" is consistent with IRS and the Seventh Circuit interpretation of I.R.C. §41.

In response to taxpayer concerns regarding T.D. 8930, on March 5, 2001, the Treasury Department and the IRS published Notice 2001-19 announcing that the Treasury Department and the IRS would review T.D. 8930 and reconsider comments previously submitted in connection with the finalization of T.D. 8930. *Comments on Research Credit Regulations*, 2001-10 I.R.B. 784, 2001 WL 84197. Notice 2001-19 also provided that, upon completion of the review, the Treasury Department and the IRS would announce changes in the regulations in the form of proposed regulations. These proposed regulations were published in the Federal Register on December 26, 2001 (the "2001 Proposed Federal Regulations"). 66 F.R. 66362-01. The resulting 2001 Proposed Federal Regulations departed from the "Discovery Test" and instead implemented the "Uncertainty Test":

> Uncertainty, for purposes of this requirement, exists if the information available to the taxpayer does not establish the capability or method of developing or improving the business component, or the appropriate design of the business component.

F.R. 66362-01 at 66363-64.

The final regulations, which replaced the "Discovery Test" with the current "Uncertainty Test" for defining qualified research under § 41(d), were promulgated on January 2, 2004 (the "2004 Final Regulations"). 69 F.R. 22-01, 2004 WL 18938.

The Indiana Legislature would presumably have been aware that the IRS and the Treasury Department were reviewing the 2001 Final Regulations shortly after their promulgation, by means of Notice 2001-19 published on March 5, 2001, and that there were concerns about the application of the Discovery Test. However, the Indiana Legislature, in 2002, after the 2001 Proposed Regulations eliminating the "Discovery Test" had already been published in December 2001, consciously selected a date prior to these revised regulations. Had the Indiana Legislature intended to adopt the "Uncertainty Test" over the "Discovery Test" in the 2003 Indiana Statute, it could have either referred to a date after the promulgation of the 2001 Proposed Regulations, waited until after the final regulations were promulgated in 2004, or not referenced any date at all. The application of the discovery

requirement was a reasonable interpretation of I.R.C. § 41(d) from the date the 1986 Act was enacted until the promulgation of the 2004 Final Regulations. Thus, the audit was correct in relying on the "Discovery Test" in determining whether Business' activities qualified for the research and expense credits. Taxpayer's argument that T.D. 9104 is applicable to the tax years at issue is misplaced. It is the Department's established position that T.D. 8930 applies to the Indiana REC prior to January 1, 2016. *See* Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017), 20170830 Ind. Reg. 045170363NRA; Letter of Findings 01-20150385 (December 6, 2016); 20170222 Ind. 045170090NRA; Letter of Findings 02-20130676 (January 16, 2015), 20150325-IR-045150065NRA. Therefore, the Department again determines that it used the correct regulations in this case.

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax - Qualified Research Expense Projects.

DISCUSSION

The issue is whether Taxpayers are entitled to claim the Indiana REC and whether Taxpayers have adequately documented to what extent they may claim the REC. In its audit of Business, the Department reviewed the REC study prepared for Business by Firm. The Department determined that none of the sampled projects included qualified REC activities and therefore disallowed all claimed RECs for the tax years at issue. Taxpayers protest that all of the claimed RECs were for qualified activities and that the claimed RECs should be allowed in their entirety.

As a threshold issue, it is the Taxpayers' responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the [D]epartment's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 897 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014). Thus, all interpretations of Indiana tax law contained within this decision, as well as the preceding audit, shall be entitled to deference.

As a basis for arriving at its conclusions, the Department's audit cited to I.R.C. § 41(d) which defines the term "qualified research" as:

1. Research with respect to which expenditures may be treated as an expense under section 174;
2. [r]esearch which is undertaken for the purposes of *discovering information* which is technological in nature (also known as the Discovery Test)[;]
3. [t]he application of which is intended to be useful in the development of a new or improved business component of the taxpayer; and
4. [s]ubstantially all of the activities which constitute elements of a process of experimentation for a qualified purpose. (*Emphasis added*).

The audit report concluded that Business was not engaged in "qualified research" under T.D. 8930 because Business was not engaged in activities that required it to obtain information that "exceeds, expands or refines the common knowledge of skilled engineering professionals." The audit found that Business' activities did not meet the definition of qualified research under I.R.C. § 41(d) because the activities were not "undertaken for the purpose of discovering information which is technological in nature . . ." and because - for an experienced company - Business' activities were an exercise but not an expansion of its "common knowledge" as skilled professionals in the design and construction industry.

While Business must meet each part of the four part test it also must properly document each part and be able to document substantiation of the credit amount. Since Taxpayers must provide proof as to Business' qualification for REC, the Department must first determine whether Taxpayers were able to substantiate the credit with proper documentation. Tax credits are a matter of legislative grace, and taxpayers bear the burden of proving they are entitled to claim tax credits. *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, where such a credit is

claimed, "the party claiming the same must show a case, **by sufficient evidence**, **which is clearly within the exact letter of the law**." *Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (**emphasis added**). Thus, Taxpayers' claims against any tax must be supported by records necessary to substantiate a claimed credit.

The audit report clearly stated that the documentation supplied by Taxpayers did not support Taxpayers' claim for RECs. As authority for its decision, the audit cited to Treas. Reg. 1.41-4(d) (TD 9104) which provides "A taxpayer claiming a credit under section 41 must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit." In addition, the audit cited to Treas. Reg. 6001-1 which states:

> Any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information.

The audit also cited to Treas. Reg. 1.41-4(d) (TD 8930) which provides as follows:

> No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer - (1) Prepares documentation *before or during the early stages of the research project*, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed (except under section 6501(c)(1), (2), or (3)) for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) Satisfies section 6001 and regulations thereunder. (*Emphasis added*).

Finally, the audit report cited to Indiana's own statute on the question of adequate documentation:

> Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts and canceled checks. IC § 6-8.1-5-4(a).

Taxpayers believe that the only record keeping requirement is set out in I.R.C. § 6001, which provides:

> Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title. The only records which an employer shall be required to keep under this section in connection with charged tips shall be charge receipts, records necessary to comply with section 6053(c), and copies of statements furnished by employees under section 6053(a).

Taxpayers are mistaken as to the standard the Department determined Business' activities did not meet. First, IC § 6-3.1-4-1 provides that "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under IC 6-3." Similar to deductions, exemptions, and exclusions, tax credits - such as RECs - "are matters of legislative grace." *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims a tax credit is required to retain records necessary to substantiate a claimed credit. Where such a credit is claimed "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974) (citing *Conklin v. Town of Cambridge City*, 58 Ind. 130, 133 (1877)). Citing *Stinson Estate*, the circuit court in *United States v. McFerrin* summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." *United States v. McFerrin*, 570 F.3d 672, 675 (5th Cir. 2009). Thus, by Indiana's own documentation standards Taxpayers have not properly recorded or documented Business' substantiation of the REC. Therefore, *regardless of whichever federal regulation applies*, Taxpayers do not meet their burden under IC § 6-8.1-5-1(c) to qualify for the Indiana REC.

However, since Indiana piggybacks off the Federal code and regulations for REC the applicable federal standard

will also be examined. As stated in Issue I, Indiana properly follows Treasury Decision 8930. Treas. Reg. § 1-41-4(d)(1) (2001) states that for a taxpayer to receive the research and development tax credit, a taxpayer must:

> *Prepare[] documentation before or during the early stages of the research project*, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed [] for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) satisfies section 6001 and the regulations thereunder. (*Emphasis added*).

As stated numerous times by the Department and again in Issue I, the 2001 federal regulations apply for tax years 2003 through 2015. *See*Letter of Findings 01-20160696; 01-20160697; 01-20160698; 01-20160700; 01-20160701; 01-20160702; 01-20160703 (June 27, 2017), 20170830 Ind. Reg. 045170363NRA; Letter of Findings 01-20150385 (December 6, 2016), 20170222 Ind. 045170090NRA. Thus, by Department precedent, until tax year 2016, Indiana follows the 2001 federal regulations.

For the projects included in Business' third-party prepared study, the Department was not convinced that any qualified for the REC. In the course of the protest process, Taxpayers provided supporting documentation an analysis that the projects did qualify for REC purposes. After review of these materials, however, the Department remains unconvinced that any of the projects included in the study and reviewed in the audit qualify for the REC. These projects do not meet the four categories listed under I.R.C. § 41(d), as discussed above. The projects included in the study were, at most, tailored for specific customers' requests without discovering new information of a technological nature. Neither were the projects intended to be useful in the development of a new or improved business component of the taxpayer nor did substantially all of the activities constitute elements of a process of experimentation for a qualified purpose.

During the protest process, Taxpayers raised the argument that one particular project was of a different nature than the other projects it undertook. Specifically, Taxpayers state that the unique project included extensive activities which would qualify as REC activities. After the administrative hearing, Taxpayers provided additional documentation, in both written and video formats, supporting its position that this project qualified for REC purposes.

The Department notes that, regardless of whether or not this project qualifies for REC purposes, this particular project was not one of those included in the REC study prepared by Firm and reviewed by the Department's audit. Therefore, even if the Department agreed that this project included qualifying REC activities, such a determination would not affect the calculations contained in the study. This, in turn, means that the discussion in the audit report would not be affected by an REC determination on this project. Neither did Taxpayers provide separate calculations or evaluations of the REC impact of this project on Business' overall REC claims. Therefore, Taxpayer's reference to this project is moot and has no impact on the Department's determinations in the audit, the proposed assessments, or the protest.

It is the taxpayer's statutory obligation to maintain and produce to the Department records sufficient to verify the credits which it claims pursuant to IC § 6-3.1-4-1 and IC § 6-8.1-5-4. Thus, Taxpayers have not substantiated its claimed credit and therefore has not met the burden under IC § 6-8.1-5-1(c).

FINDING

Taxpayers' protest is denied with respect to the issue of documentation.

SUMMARY

The Department does not agree that Business was entitled to rely on the "Uncertainty Test" in evaluating whether it was entitled to claim the RECs, that Business was entitled to claim and pass through the credits to Taxpayers, or that Taxpayers documented to what extent they could claim the RECs based on wages paid to Business' employees.

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